COMMONWEALTH OF KENTUCKY

BEFORE THE PUBLIC SERVICE COMMISSION

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In the Matter of:

ADJUSTMENT OF RATES OF GENERAL TELEPHONE COMPANY OF KENTUCKY	)))	CASE NO. 8045

ORDER ON REHEARING

On June 3, 1981, General Telephone Company of Kentucky ("Company") filed a petition for rehearing of the Commission's Order in Case No. 8045, issued on May 15, 1981. The Company's petition requested rehearing on the following issues:

1. Deferral of change in depreciation rates on central office equipment ("COE").

2. Deferral of implementation of remaining-life depreciation on station equipment accounts.

3. The range of returns of 12.5% to 13.5% found reasonable for common equity; the establishment of the return on equity at 13%; and the resulting conclusion that the overall cost of capital was 10.72%.

4. The fixing of the cost rate for short-term debt at 13.75%.

5. Calculation of income taxes used to determine General Telephone Company's additional revenue requirements.

6. Directive to refile certain schedules in the annual report; include in future annual reports depreciation rates approved in the most recent general rate case; and secure

approval of changes in depreciation rates in general rate increase proceedings.

7. The Company's objection to portions of the testimony of Mr. Ben Johnson, witness for the Attorney General, relating to double leverage.

8. Disallowance of contractually-committed additions to telephone plant.

9. Disallowance of full normalization of income taxes.

10. Adjustment to toll revenues resulting from the increase awarded South Central Bell in Case No. 7774.

The Commission entered an Order on June 19, 1981, granting the Company's request for rehearing and requiring the prefiling of Company testimony. The Company prefiled testimony of Mr. Harlan E. Rollin III on the issue of changes in depreciation rates.

On July 14, the Attorney General filed the testimony of Mr. Ben Johnson on the issue of fair rate of return for common equity.

Pursuant to notice duly given, the rehearing was held on July 15, 1981, at the Commission's offices in Frankfort, Kentucky. The case was submitted to the Commission for final determination on the record.

Depreciation Expense

The Company presented the testimony of Mr. Rollin, Vice President, Network Engineering and Construction, regarding the commitments made by management for conversion of COE from electronic to digital switching equipment. The growth rate and the demand of customers for new services have resulted in a decision to convert from electronic to digital COE. When conversion occurs the entire central office must be changed from electronic to digital. He provided engineering schedules ("pert charts") as a late filed exhibit.

The Commission has carefully reviewed the Company's testimony and exhibits relating to depreciation on COE. The Company is on schedule and is, in fact, experiencing shorter lives on existing COE. Therefore, the Commission concludes that the Order issued on May 15, 1981, should be modified to allow an increase in intrastate depreciation for COE of $1,130,003. The effect of this adjustment is a reduction in operating income (net of the toll effect) of $497,831.

On rehearing, Mr. Rollin also addressed the change in the method of computing depreciation from straight-line vintage to remaining-life on existing investment in, and equal life on new additions to, the station equipment accounts. The Company requested this change for these plant accounts, maintaining that it had shown its records included sufficient detail to permit implementation of this method.

The Commission takes notice of the Company's application in Case No. 8295 wherein it seeks to implement the remaining-life method for all existing plant accounts and the equal-life group method for all new additions to plant and to recover the increase in depreciation resulting from implementing these methods. This change and any associated increase in rates should be deferred and consolidated in Case No. 8295. Therefore, the Commission concludes that its Order of May 15, wherein it deferred the Company's proposal, should not be modified in this regard.

In the May 15 Order, the Commission approved the expensing of station connections on a phased-in basis. In fixing rates, the Commission included an amount equal to 25% of the annual cost of station connection activity. Under this phased-in approach the level of the Company's expense will increase by 25% of the annual cost of station connection activity on May 15, 1982. The Commission concludes that its Order issued on May 15, 1981, should be modified to allow the Company to file tariffs 20 days prior to May 15, 1982, 1983 and 1984, limited specifically to recovery of increased cost related to the expensing of station connections. The Company must demonstrate that based on actual results, adjusted to reflect the annual effect of all rate increases, absorption of this increase in expense would result in the Company's inability to achieve the return on equity approved in its most recent rate case.

Return on Common Equity

The Company offered no testimony on the issue of fair return on equity. However, it did present extensive oral argument in which it maintained that its current cost of long-term debt is approximately 15%.[1] Thus, the Company argues that the cost of equity is equal to or greater than the current cost of

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[1] GTKY Rehearing Exhibit 66.

long-term debt and that any return below that cost results in confiscation.

The Attorney General's Consumer Protection Division presented the direct testimony and exhibits of Mr. Johnson who addressed specifically the Company's allegation that the cost of equity is not less than the current cost of long-term debt.

Witness Johnson explained that the spread theory (i.e., the differential between current long-term debt cost and equity cost) is based on the premise that the required rate of return increases as the investment risk increases. The assumption underlying this theory is that there is higher risk associated with investments in common stock than investments in bonds. This assumption leads to the argument that a consistent positive spread exists between yields on common stock and yields on bonds, and that the cost of common equity is then determined by adding the spread to the current yields on bonds.

Mr. Johnson presented a number of comparisons of equity costs with various types of debt issues and concluded that there was no consistent correlation between the cost of equity and the <u>current</u> yields on debt. In fact, he concluded that significant variations occurred from year to year, that the spread has narrowed in recent years, and that in certain circumstances the spread theory produces unreasonable results.

Mr. Johnson stated six factors which support the theory that the cost of debt can exceed the cost of equity. These six factors are: consistent fluctuations in the spread between current debt and equity cost suggest there is nothing to prevent the spread from being negative; second, Federal Reserve Board policies affect equity and bond costs differently; third, tax differences exist between debt and equity because of capital gains treatment; fourth, bond yields are locked in but returns on equity can fluctuate with economic conditions; fifth, bond price movement is asymmetrical whereas equity is two-sided; and sixth, the risk of hyper-inflation is much greater with bonds than common stocks. For these reasons, he concludes that the appropriate spread between the cost of common equity and the current cost of debt can be negative.

The Commission is not convinced that the cost of common equity will at every point in time exceed the current cost of long-term debt. The relationship between cost rates on different financial instruments traded in different financial markets changes with market conditions. For example, interest rates on short-term debt are at times much higher than interest rates on long-term debt, and at other times the relationship is reversed.

The Commission is not bound to the use of any single formula in determining rates, but may make such "pragmatic adjustments" as are called for by the particular circumstances of the case.[2] In the distant past, it might have been appropriate to assume

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[2] Federal Power Commission v. Hope Natural Gas, 320 U.S. 590, 602 (1944); Federal Power Commission v. Natural Gas Pipeline, 315 U.S. 575, 586 (1942).

that investors insisted on higher yields on common stocks than on bonds.[3] Such assumptions are inappropriate in this time of unpredictable financial conditions.

In Hope, the Supreme Court upheld the FPC decision, noting that it had considered the yields on the bond issues of various companies over the course of the immediately preceding years in setting a rate of return on equity. That procedure was reliable since it took into consideration a number of bonds issued over a span of time so as to correct for any irregularities that may have occurred in the short run. This Commission would ignore Hope if it were automatically to set a rate of return on equity above the yield on a single bond issue. A valid use of the risk premium methodology requires the examination of appropriate bond issues over a sufficient period of time to correct for abnormalities within that period. Furthermore, even when a risk premium analysis is validly performed, this Commission must consider all evidence on the issue of the rate of return on equity, including other methodologies, before finding any particular rate of return on equity to be fair, just and reasonable.

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[3] McCardle v. Indianapolis Water Company, 272 U.S. 400, 419 (1926); Denver v. Denver Union Water Company, 246 U.S. 178 (1918).

The Commission is aware that since late 1979 interest rates have been at historically high levels, prospective inflation rates have been high and uncertain, and the Federal Reserve Board has been pursuing restrictive credit policies. Considering the instability in current financial markets, the relationship between equity costs and interest rates is highly unstable. The Commission is convinced that basing an estimate of the cost of equity on current interest rates would be improper at this time.

In its May 15 Order, the Commission found the range of fair return on common equity was 12.5 to 13.5%. The Company's argument that the only testimony supporting this finding is based on a double leverage analysis is not supported by the record. In fact, Mr. Johnson testified:

> However, it is interesting to note that if the Commission doesn't consider the parent-subsidiary adjustment, the overall cost of subsidiary equity will still be relatively similar to that which I have recommended. This would occur, because the cost of equity I have recommended on the basis of the comparable earnings approach was increased to be consistent with the lower imputed equity ratio I have used. If the subsidiary capital structure were used without considering the effects of double leverage, a lower equity cost rate than 12.5% to 13.5% would be appropriate. This cost rate would undoubtedly be relatively similar to the 11.8% to 12.5% cost of subsidiary equity which I calculated after considering the effects of double leverage.[4]

[4] Johnson's prefiled testimony, pp. 84-85.

In determining the additional revenue needs of the Company, the Commission used 13%, the midpoint of the above range. In selecting the midpoint, the Commission considered, among other things, the adjustments made to update the test year for known changes; the Company's actual financial data which show its achieved earnings have approximated the return on equity allowed in Case No. 7669; and the current administration's aggressive policy geared to controlling inflation and encouraging capital formation for private investment. The Commission has carefully considered recent economic events. While the rate of increase in inflation has recently abated, the current cost rate on new debt issues remains relatively high. The Commission believes this results from continuing uncertainty as to future rates of inflation and Federal Reserve policies.

Based on the foregoing analysis, the Commission is persuaded that a return on equity within the range of 13 to 14% is fair, just and reasonable. Further, the Commission is persuaded that the Company will be afforded a reasonable opportunity to earn a return on equity within this range if rates are fixed based on a common equity return near the upper end of this range. Therefore, in computing the additional revenue required by the Company, the Commission will modify its May 15 Order to increase the return on equity to 13.75%. This increases income requirements by $771,517.

Cost Rate For Short-Term Debt

The Company argued that no witness testified that the short-term debt rate established by the Commission was a reasonable expected cost rate and that the established debt rate appeared to be based on Mr. Mason's testimony as to the sale of commercial paper on one day. In its oral presentation on rehearing, the Company reviewed the testimony of Mr. Mason and Mr. Johnson on short-term debt costs and presented an exhibit showing its average commercial paper cost for February through June of 1981 at 16.425%.[5]

In its Order of May 15, 1981, the Commission summarized the testimony of Mr. Johnson and Mr. Mason and established a short-term debt cost rate of 13.75%. In selecting that cost rate, the Commission considered actual test-year, short-term debt costs and recent trends in interest rates as well as the recommendations of the expert witnesses. The Company's short-term debt cost averaged approximately 12.5% for the test year.[6] Mr. Mason testified that the Company used commercial paper for most of its short-term debt financing. The average interest rate for 90-day commercial paper for the 12 months ended April 1981 was approximately 12.75%.[7] Given these costs and trends, the Commission found 13.75% to be a reasonable estimate of future short-term debt costs.

Since May, interest rates have continued at historically high levels. The average interest rate for 90-day commercial

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[5]General Telephone's Rehearing Exhibit, page 40.

[6]Calculated from information provided in response to Items 3m and 3n of Staff Request #1.

[7]Federal Reserve Statistical Release, 90-Day commercial paper rates for firms with AA bond ratings or equivalent.

paper for the 12 months ended June 1981 was approximately 14.1%.[8] Considering current trends in interest rates and the Company's recent short-term debt cost experience, as presented on rehearing, the Commission has determined that 14.5% is a reasonable estimate of future short-term debt costs. The Commission concludes that its May 15 Order should be modified to reflect a cost rate for short-term debt of 14.5%. The net effect is an increase in net operating income of $17,478.

Rate of Return Summary

Applying a cost of common equity of 13.75% and a cost rate for short-term debt of 14.5% to the appropriate equity and debt components of the capital structure approved in the May 15 Order produces a weighted cost of capital of 11.06%. This cost of capital then produces a rate of return on the Company's net investment rate base of 10.93%, which the Commission finds is the fair, just and reasonable return in that it is sufficient to provide the Company reasonable compensation for the service it renders to its customers.

Calculation of Income Taxes

After reviewing the total record, the Commission finds that two items which were omitted from its May 15 Order should now be included. The first item concerns revenue requirements for income taxes and the deduction for the amortization of investment tax credit. The inclusion of this deduction adds $1,271,856

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[8] Federal Reserve Statistical Release, 90-Day commercial paper rates for firms with AA bond ratings or equivalent.

to end-of-period operating income. The second item involves interest during construction in the amount of $793,601 which was not included in operating revenue used to calculate taxable income. The Commission now concludes that this amount should be included. Such inclusion adds $402,832 to the net income for return. The Commission concludes that the May 15 Order should be modified to reflect these findings.

Directive to Refile Certain Annual Report Schedules

In the Order issued on May 15, the Commission pointed out that the Company had changed certain depreciation rates and had reflected these changes in its 1980 annual report filed with the Commission. The Commission was concerned because the Company made these changes without prior approval of the Commission. On oral argument, the Company stated that its actions in this regard were consistent with past policy. Subsequent to the rehearing, the Company has filed with the Commission a depreciation study and a request for change in depreciation rates.

The Commission's review of the 1980 annual report reveals that these depreciation changes occurred in late 1980. The amount booked for this period did not have a material impact on the Company's operating results. Therefore, the Commission will modify its Order of May 15 to eliminate the requirement to refile the affected schedules in the 1980 annual report. However, the Commission serves notice that changes in depreciation rates resulting from studies performed by the Company are not to be implemented without prior approval of this Commission.

The Commission will further clarify its May 15 Order with respect to the timing of changes in depreciation rates. In that Order, the Commission indicated that an appropriate time to seek changes in depreciation rates would be in a general rate proceeding. This is not the only time to make changes in depreciation rates. Such changes can be made by filing appropriate, well-documented depreciation studies with the Commission. When a company requests an increase in rates to cover increases in depreciation expense, it has the burden of showing that absorption of the increase will result in its inability to achieve the return on equity allowed in its most recent rate case.

Objection to Double Leverage Testimony

The Company has asked the Commission to rule on its objection to the admission of Mr. Johnson's testimony regarding double leverage. It argues that application of this theory results in piercing of the corporate veil, in contravention of Kentucky law. As the Commission did not apply double leverage in reaching its decision in this case, admission of the testimony could not have been prejudicial. Nevertheless, the Commission will consider the merits of the Company's argument.

The Company claims that none of the criteria required in White v. Winchester Land Development Corporation[9] for piercing the corporate veil were proved and therefore that a proper foundation for admission was not laid. Clearly, the criteria articulated in the White opinion must be proven to justify

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[9] Ky. App., 584 S.W.2d 56 (1979).

holding shareholders personally responsible for corporate liabilities. However, that is not the issue before this Commission. In the context of this rate-making proceeding, it is the Commission's task to prescribe fair, just and reasonable rates. Such rates are a function of various costs, including the cost of equity. Of necessity, the Commission must examine all the evidence which bears on that cost, including advantageous parent-subsidiary relationships. Accordingly, the Commission concludes that the objection of the Company to those portions of the testimony, exhibits and appendix of Mr. Johnson which relate to double leverage should be overruled.

Other Issues

Neither the Company nor the intervenors raised any new or substantial evidence on rehearing with regard to the issues of income tax normalization, toll revenue adjustment, or committed purchases adjustment. Therefore, the Commission confirms the findings in its May 15 Order on these issues.

Based on the foregoing modifications to the May 15 Order, the Commission concludes that the adjusted net operating income should be increased from $20,114,321 to $21,308,656; the net income found reasonable should be increased from $25,983,491 to $26,790,505; the deficiency should be decreased from $5,869,170 to $5,481,849; and the deficiency adjusted for taxes should be decreased from $11,562,589 to $10,799,545.

From the foregoing analysis of the evidence of record in this case, the Commission finds that:

(1) The rate schedules attached hereto as Appendix A are fair, just and reasonable, and such rates are equitable and nondiscriminatory as between customers and classes of customers and should be approved.

(2) The Company should request Commission approval of all proposed changes in depreciation rates; and when it requests rates to cover such changes, it bears the burden of proving that the absorption of these changes will materially impair the ability of the Company to achieve the return on equity allowed in its most recent general rate case.

(3) The Company should be allowed, on 20 days' notice, to make a limited filing for recovery of the annual increase in expense associated with the phase-in of the change from capitalizing to expensing the cost of station connections.

IT IS THEREFORE ORDERED that the schedule of rates approved by the Commission's Order of May 15, 1981, be and is hereby rescinded.

IT IS FURTHER ORDERED that, effective with the date of this Order, the Company is hereby authorized to place into effect the schedule of rates set out in Appendix A, attached hereto and made a part hereof.

IT IS FURTHER ORDERED that, within 20 days from the date of this Order, the Company shall file its tariffs with the Commission which will produce $118,357,633 based on station development at July 31, 1980.

Done at Frankfort, Kentucky, this 4th day of September, 1981.

PUBLIC SERVICE COMMISSION

Marlin M. Volz
Chairman

Katherine Randall
Vice Chairman

Linda Harrigan
Commissioner

ATTEST:

Secretary

APPENDIX A

APPENDIX TO AN ORDER OF THE PUBLIC SERVICE COMMISSION IN CASE NO. 8045 DATED SEPTEMBER 4, 1981.

The following rates and charges are prescribed for the customers in the area served by General Telephone Company of Kentucky. All other rates and charges not specifically mentioned herein shall remain the same as those in effect under authority of the Commission prior to the date of this Order.

BASIC LOCAL EXCHANGE RATE SCHEDULE

Statewide Flat Rate Schedule

Group	Total Network Access Lines	Rates Per Month					
		Residence			Business		
		1-Pty	2-Pty	4-Pty & Rural	1-Pty	2-Pty	Rural*
1	0- 2,000	$ 9.20	$ 7.37	$ 6.44	$20.61	$17.52	$14.43
2	2,001- 2,300	9.34	7.47	6.54	20.90	17.76	14.63
3	2,301- 2,650	9.49	7.58	6.63	21.23	18.04	14.86
4	2,651- 3,050	9.65	7.71	6.75	21.55	18.32	15.09
5	3,051- 3,500	9.77	7.81	6.84	21.90	18.63	15.33
6	3,501- 4,000	9.92	7.94	6.94	22.24	18.90	15.56
7	4,001- 4,600	10.07	8.04	7.06	22.74	19.33	15.92
8	4,601- 5,300	10.21	8.17	7.15	23.28	19.80	16.30
9	5,301- 6,100	10.36	8.29	7.24	23.83	20.25	16.68
10	6,101- 7,000	10.53	8.42	7.37	24.41	20.75	17.09
11	7,001- 8,050	10.69	8.55	7.48	25.01	21.25	17.51
12	8,051- 9,250	10.85	8.68	7.58	25.60	21.77	17.92
13	9,251-10,650	11.01	8.81	7.71	26.21	22.28	18.34
14	10,651-12,250	11.17	8.94	7.81	26.84	22.82	18.80
15	12,251-14,100	11.33	9.07	7.93	27.45	23.33	19.22

*Business rural rates apply to existing business four-party service.

Semi-Public Telephone	50% of Business 1-Party
Key Telephone Trunk	175% of Applicable 1-Party Rate
PBX Trunk	200% of Applicable 1-Party Rate

The above rates for basic local exchange service are related to the total number of Network Access Lines including one- and multi-party lines, public and semi-public lines, Centrex lines, ETSX lines, and all types of trunk lines within the local calling area.

Rates for basic local exchange service apply to Network Access Lines only. Telephone Company-provided station sets and other terminal equipment rates and charges are listed in appropriate sections of the Company tariff.

BASIC LOCAL EXCHANGE RATE SCHEDULE (Continued)

Statewide Flat Rate Schedule

Group	Total Network Access Lines	Rates Per Month					
		Residence			Business		
		1-Pty	2-Pty	4-Pty & Rural	1-Pty	2-Pty	Rural*
16	14,101- 16,200	$11.51	$ 9.21	$ 8.06	$28.07	$23.86	$19.65
17	16,201- 18,650	11.68	9.35	8.18	29.20	24.83	20.44
18	18,651- 21,450	11.88	9.51	8.32	30.84	26.21	21.59
19	21,451- 24,700	12.05	9.65	8.43	31.41	26.69	22.00
20	24,701- 28,400	12.21	9.77	8.56	31.97	27.19	22.39
21	28,401- 32,650	12.40	9.92	8.68	32.50	27.62	22.74
22	32,651- 37,550	12.57	10.06	8.80	33.02	28.07	23.11
23	37,551- 43,200	12.77	10.22	8.95	33.59	28.56	23.51
24	43,201- 49,700	12.97	10.38	9.08	34.18	29.05	23.92
25	49,701- 57,150	13.16	10.53	9.21	34.76	29.55	24.32
26	57,151- 65,700	13.36	10.69	9.35	35.41	30.11	24.79
27	65,701- 75,550	13.55	10.85	9.50	36.05	30.65	25.24
28	75,551- 86,900	13.75	11.00	9.62	36.84	31.32	25.80
29	86,901- 99,950	13.97	11.17	9.77	37.71	32.05	26.39
30	99,951-114,950	14.18	11.35	9.93	38.57	32.79	27.00
31	114,951-132,200	14.41	11.52	10.09	39.42	33.52	27.60
32	132,201-152,050	14.61	11.68	10.22	40.30	34.25	28.22
33	152,051-174,850	14.82	11.86	10.37	41.17	35.00	28.82
34	174,851-201,100	15.04	12.04	10.53	42.14	35.81	29.49
35	201,101-231,250	15.28	12.23	10.70	43.09	36.61	30.16

*Business rural rates apply to existing business four-party service.

Semi-Public Telephone	50% of Business 1-Party
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The above rates for basic local exchange service are related to the total number of Network Access Lines including one- and multi-party lines, public and semi-public lines, Centrex lines, ETSX lines, and all types of trunk lines within the local calling area.

Rates for basic local exchange service apply to Network Access Lines only. Telephone Company-provided station sets and other terminal equipment rates and charges are listed in appropriate sections of the Company tariff.